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C O N F I D E N T I A L TOKYO 003417

SIPDIS

TREASURY IA FOR FOSTER

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SUBJECT: BOJ BUSINESS SENTIMENT INDEX RECORDS STEEPEST FALL
IN 33 YEARS

Classified By: Ambassador J. Thomas Schieffer; reasons 1.4 (b/d)

11. (C) Summary: The Bank of Japan's quarterly Tankan survey of business sentiment, a closely watched business cycle indicator and a principal input in the central bank's monetary policy deliberations, revealed a drastic across-the-board deterioration in business sentiment among large, medium sized, and small firms, primarily reflecting an intensifying weakness in domestic and external demand and greater uncertainty about unfolding financial market turmoil.

This appears to reinforce market concerns that the present recession is broadening and deepening. The survey's headline business sentiment diffusion index for large manufacturers was largely in line with, or a bit worse than private analysts' expectations. The Bank of Japan (BOJ) Policy Board is scheduled to hold its first post-Tankan meeting on December 18 and 19. Some market observers expect the BOJ to cut its operating target for the overnight call money rate by 20 basis points to 0.1%. End Summary.

Business Conditions

12. (C) The closely watched diffusion index for large manufacturers, the percentage of companies replying that business conditions are "favorable" minus the percentage replying that conditions are "unfavorable", declined from -3 in September to -24 in December, representing the steepest fall in business sentiment since February 1975 (after the first oil shock), and the lowest level since March 2002. The diffusion index was slightly below market expectations of -23. The diffusion index for large non-manufacturing enterprises worsened from 1 in September to -9 in December, with pessimists outnumbering optimists for the first time since December 2003. Among small and midsize enterprises, both manufacturing and non-manufacturing firm business sentiment worsened considerably in December.

Capital Spending

13. (SBU) Across all categories of surveyed firms, companies expected to reduce investment spending by 2.8% in FY2008, down 1.5 percentage points from September. This mainly reflects a downward revision among large and midsize firms. Investment by large firms is projected to decline 0.2% in FY2008, representing a downward decline of 1.8 percentage points from September.

Employment Diffusion Index

14. (SBU) The Tankan survey also showed firms' perceptions of over-employment increased notably. The employment conditions diffusion index, the percentage of firms replying that they have "excess employment" minus the percentage of

firms replying that they have "insufficient employment", rose from -2 in September to 4 in December, with over-employment outnumbering insufficient employment for the first time since September 2004.

Corporate Finance

15. (SBU) In addition, the Tankan survey indicated firms' perceptions of financial institutions' lending attitudes deteriorated considerably in December. The lending attitude of financial institutions diffusion index, the percentage of firms replying that lending attitudes are "accommodative" minus the percentage of firms replying that they are "severe", fell from 3 in September to -6 in December, with the "severe" perception outnumbering the "accommodative" perception for the first time since September 2003.
SCHIEFFER